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MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

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SUBJECT: Status Report on Problem Countries

The Federal Reserve, State and Treasury are following closely the financial difficulties currently being experienced by a dozen-odd countries in which the United States has a special interest. Recent developments in Mexico, Argentina, Sudan and Zaire are of particular significance.

MEXICO

The Mexican economic situation remains precarious. While the trade account is somewhat stronger and capital flight may be abating, capital inflows are not sufficient to meet short-term foreign exchange needs. The recent $2.5 billion "jumbo" loan was poorly received by the market. Banks are very reluctant to increase their exposure. The GOM will not be able to float a large syndicated loan for at least several months, if not longer. The GOM will be forced to rely on rollovers of maturing credits and "club deals" that bring in $50 to $100 million at a time. July and August will be particularly difficult months. (C)

Adding to existing problems, on September 1 President Lopez Portillo will deliver the annual State of the Union Address (his last). Traditionally Bank of Mexico reserves are announced. The President will want to announce a figure as large as the $3.9 billion announced for the end of May -- which he is very unlikely to be able to do. A complicating factor is that pressure on the peso usually picks up on the anniversary of previous devaluations, i.e., August 31. (C)

Establishment of confidence in the willingness of the GOM to implement strong corrective measures remains the key to overcoming the continuing financial crisis. Only private capital markets can provide the amount of financing the Mexicans require. Now that the election is over, the GOM must announce convincing implementing measures, e.g., more price increases for public sector goods and services, further budget cuts, interest rates high enough to remain positive in real terms and an accelerated depreciation of the peso. The international banking community already expects considerable tightening up in the stabilization program. If this does not occur, the foreign financing situation could deteriorate rapidly. (C)

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The Treasury and Federal Reserve swaps, even under circumstances appropriate to their use, are necessarily short-term and limited in amount. President Lopez Portillo, who will remain in office until December 1, remains opposed to recourse to the IMF. However, borrowing from the Fund may become unavoidable both for confidence and direct financing reasons. (C)

ARGENTINA

The new Argentine government of President Bignone appears to be taking a mid-course between the austerity measures of his immediate predecessors and the statist approach of Argentina's traditional political parties, including the Peronists. The new Minister of Economy, Jose Maria Dagnino Pastore, announced a series of major economic policy changes during the first week of July; capped by a 22% devaluation of the peso and a return to a dual exchange rate system. A "commercial" rate will be pegged daily for trade transactions. A "financial" rate for tourists, debt service and other payments will reflect "the free play of market forces." The "financial" rate moved quickly to a discount of 35% from the official rate on July 6. The government has also eliminated the requirement that all external payments be approved by the Central Bank. This requirement had caused chronic delays in private debt service since the measure was adopted on April 30. Foreign exchange purchases for non-debt related payments -- including imports -- continue to be tightly controlled. (LOU)

Argentina's liquid foreign exchange reserves -- now estimated at $600-$800 million -- continue to erode. The Central Bank, however, claims to still have $1.1 billion in bilateral trade swaps available within the region and $1.5-$2.0 billion in letters of exchange potentially available for discount on foreign financial markets. These are in addition to $1.3 billion in gold reserves. Argentina could also use its nearly $640 million of SDR holdings and reserve tranche in the IMF. (C)

U.S. banks (with the exception of some smaller, regional, institutions) continue to roll over maturing Argentine debts into new short-term obligations. Argentine sources claim that as much as 90% of maturing obligations are being rolled over; compared to only 75% during the peak of hostilities in May. The GOA is currently attempting to negotiate several club deals in the $50-$150 million range with U.S. banks and at least one new commercial bank credit line to an Argentine bank (for $130 million) has been arranged. Hard currency liquidity is nonetheless very tight, in part because of Venezuela's failure to actually deposit $1 billion in foreign exchange holdings in Argentine banks as promised in May. (C)

Argentine officials hope to restructure external debt in the months ahead through a consolidation of short-term public sector obligations into club loans led by major U.S. banks. While the GOA does not wish to seek an IMF standby due to internal political considerations, a technical assistance mission has gone to Argentina to evaluate the situation and suggest corrective economic measures.

An IMF stand-by arrangement may still prove necessary to avoid an unacceptably low level of reserves and mounting commercial arrearages in the fourth quarter. (C)

SUDAN

In February, the IMF approved a one-year SDR 198 million standby in support of a stabilization program covering CY 1982. There was also a special pledging session in January (U.S. share = $125 million) and a Paris Club debt rescheduling in March (U.S. share $50 million). Since mid-May, the Government of Sudan has been out of compliance with the IMF standby because of failure to eliminate arrears relating to payments due under the 1979 Paris Club rescheduling. There is also an unresolved issue with the IMF concerning Sudan's exchange rate policy. Accordingly, the IMF has withheld release of SDR 35 million, which would have been available at the end of June. (LOU)

The Government of Sudan missed an interest payment of about $23 million due to commercial banks and under a "London Club" debt-relief agreement concluded last December, it has informed the banks that it will be unable to meet the September payment as well. One of the leading U.S. banks is threatening to declare Sudan in default, although there is probably a large element of bluff in this threat. (C)

The extremely precarious external financial position of Sudan is not new. It was well understood at the time the IMF arrangement was approved that Sudan would have a serious cash flow problem throughout 1982. However, export earnings and aid disbursements appear to be substantially lower than projected at the beginning of the year, and the situation is now at a critical stage. (LOU)

A recent review of the "Horn of Africa" by the NSC has concluded, among other things, that the USG should strongly encourage continued Sudanese economic reform and austerity measures. Specifically, the review recommends that an interagency working group examine options for meeting Sudan's needs for financial assistance including debt relief. This examination could be undertaken within the CCEA's Working Group on LDC Financial Problems, with State taking the lead. (C)

ZAIRE

Zaire is experiencing serious foreign exchange shortages and accumulating arrears to private and official creditors as a result of economic mismanagement. Depressed world prices for copper and other commodities have contributed to Zaire's difficulties. To maintain the flow of donor aid since mid-1981, Mobutu has emphasized political relations (such as recognizing Israel) rather than economic reforms. (LOU)

Significant FMS arrearages have held up FY 1981 and FY 1982 military assistance in the form of Federal Financing Bank loans at market-related interest rates (guaranteed by the Department of Defense). An interruption of our military assistance programs would presumably have an adverse impact on USG-GOZ political relations. (LOU)

Relations with the IMF are at an all time low. The 3-year, $1 billion extended arrangement was cancelled last month, just one-year after it was approved, because the GOZ failed to meet its September 1981 performance targets and was unwilling to implement the policy reforms necessary to reestablish its eligibility for Fund credit. (LOU)

Debt relief arrangements are in limbo. The GOZ has failed to sign all but one of the bilateral agreements implementing the July 1981 Paris Club agreement that set debt-relief terms for 1981 and 1982. This situation threatens the effectiveness of the Paris Club approach to debt relief. Meanwhile, Zaire has paid only part of the interest due in April 1982 to commercial banks under a debt-relief agreement concluded in 1979. The banks have taken the position that nonpayment is unacceptable. (LOU)

From an economic/financial perspective, U.S. policy toward Zaire should emphasize the necessity for Zaire to implement the necessary economic adjustment measures and negotiate a new standby arrangement with the IMF. (C)

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